

Memorandum

Date: March 1, 2004

To: The Commission

From: **Kenneth K Louie, Chief, Audit & Compliance Branch**
Izetta Jackson, Director, Water Division

Subject: *Rate of Return for Small Water Utilities (Class C and Class D)*

This memorandum updates the Water Division's recommended rates of return for Class C (<2,000 customers) and Class D (<500 customers) water companies, as required by D.92-03-093 in Phase I of I.90-11-033 (Water Risk OII).

Based on our analysis of financial market changes within the last year and the high operational risks faced by Class C and Class D water companies, we are recommending no change in the return ranges for Class C and Class D water utilities informal general rate cases. For 2004, we are recommending Return on Equity (ROE) ranges of:

Class C – 11.65% to 12.65% (no change from last year)

Class D – 12.40% to 13.40% (no change from last year)

In setting rates of return for other utilities, the Commission has recognized changes in interest rates as well as the economy generally. At the same time, the Commission has cautioned against lock-step conformity to these factors. The Water Division's Audit & Compliance staff has developed its recommendations accordingly.

- **Financial Market Outlook:** Overall, interest rates have decreased since last year. As of February 2004:
 - The average yield on 90-day Treasury Bills is .92%, as compared to 1.03% for 2003, representing an 11 basis point decrease;
 - The average yield on a 1-Year Treasury is 1.25%, as compared to 1.24% for 2003, representing a 1 basis point increase;
 - The average yield on a 5-Year Treasury is 3.10%, as compared to 2.97% in 2003, representing a 13 basis point increase; and
 - The average Long-term Treasury is 5.03%, as compared to 4.96% in 2003, representing a 7 basis point increase.

- It should also be noted that the interest rate forecasts for 2004 are somewhat higher than those experienced in 2003:
 - 90-day Treasury bill is forecast to be 1.10%,
 - 1-Year Treasury is forecast to be 1.57%,
 - 5-Year Treasury is forecast to be 3.39%, and
 - Long-Term Treasury is forecast to be 5.30%.

In developing its ROE recommendations, Water Division's Audit & Compliance staff also observes any changes from the previous year's authorized returns for Class A water companies.

- Authorized ROE's for Class A water utilities have remained fairly constant since last year, averaging 9.93% in 2003.

Water Division staff also evaluates the high risk factors inherent in the Class C and Class D water companies, taking into account that:

- ROE should be high enough to encourage rate base investment, and
- ROE should be well above the cost of debt. This compensates owners of small water companies for financing water plant with personal borrowings, which is risky. Small water companies are still prone to business failures and uncompensated takeovers.

In D.92-03-093, the Commission has allowed rate of return to be set at a level above or below the recommended ranges if warranted by the facts of a particular case and established the 1992 standard returns shown for Class C and Class D water utilities. Thus, our recommended returns are stated as "ranges" so that Water Division staff may recognize differences in such items as water and service quality and management effectiveness, on a case-by-case basis. Since that time, several risk-reducing Commission policies have been added, including Automatic CPI offset procedure, Extraordinary expense memo accounts, Catastrophic Event Memorandum Account, Service Guarantee Plan, and Purchased Power/Water balancing accounts.

The table below provides a historical perspective on the recommended return on equity for the small water companies. Any questions regarding this recommendation may be directed to Sean Wilson of the Water Division (1-415-703-1818, smw@cpuc.ca.gov).

Year	Recommended ROE Range		Federal Reserve Statistics			
	Class C Water	Class D Water	90-day Treasuries	1-Year Treasuries	5-Year Treasuries	Long-Term Treasuries
1994	11.30% - 11.80%	13.60% - 14.10%	4.37%	5.32%	6.69%	7.37%
1995	13.00% - 13.50%	14.00% - 14.50%	5.66%	5.94%	6.38%	6.88%
1996	12.00% - 13.00%	12.755 - 13.75%	5.15%	5.52%	6.18%	6.71%
1997	12.50% - 13.50%	13.50% - 14.50%	5.20%	5.63%	6.22%	6.61%
1998	12.00% - 13.00%	12.75% - 13.75%	4.91%	5.05%	5.15%	5.58%
1999	12.00% - 13.00%	12.75% - 13.75%	4.78%	5.08%	5.55%	5.87%
2000	12.25% - 13.25%	13.00% - 14.00%	6.00%	6.11%	6.16%	5.94%
2001	12.00% - 13.00%	12.75% - 13.75%	3.48%	3.49%	4.56%	5.49%
2002	11.75% - 12.75%	12.50% - 13.50%	1.64%	2.00%	3.82%	5.43%
2003	11.65% - 12.65%	12.40% - 13.40%	1.03%	1.24%	2.97%	4.96%
2004	11.65% - 12.65%	12.40% - 13.40%	0.92%	1.25%	3.10%	5.03%

NOTE: 2003 Average Interest Rates as of February 2004